United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-6045

IN THE UNITED STATES COURT OF
APPEALS FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-appellee,

v.

RALPH T. IANNELLI, HOWARD
FROST and JOHN SURGENT,

Defendants.

JOHN SURGENT,

Defendant-appellant

Appeal from the United States District Court
for the Southern District of New York

ANSWERING BRIEF OF THE SECURITIES
AND EXCHANGE COMMISSION, APPELLEE

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ANSWERING BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

COUNTERSTATEMENT OF THE ISSUE PRESENTED

Whether the district court properly entered an injunction against the defendant-appellant based upon its findings that he knew or should have known that he was aiding and abetting others in an admitted manipulation of the market in an over-the-counter security, effected by a

broker's driving up the price by substantial purchases in the names of customers who had not ordered the security, when the evidence adduced by the Commission at trial showed, inter alia, (1) that defendant-appellant was a knowledgeable securities trader; (2) that he (a) purportedly ratified unauthorized purchases that had been made for the broker's customers by falsely stating to the broker's superior that certain of the purchases had been intended for defendant-appellant's account and (b) arranged that he be given confirmations falsely stating that these transactions had not been confirmed to him earlier due to computer error, when, in fact, they had not been originally made for his account; and (3) that by these activities he expected to realize a substantial profit without risk to himself.

COUNTERSTATEMENT OF THE CASE

This is an appeal from an order of the district court permanently enjoining John Surgent from further violations of the anti-fraud provisions of the federal securities laws (App. 33a[1/]).

In enjoining Mr. Surgent, the district judge found that he was "a sophisticated, knowledgeable trader in securities and knew or should have known that he was aiding and abetting illegal activity on the part of [Ralph T.] Iannelli," one of his co-defendants. Moreover,

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1/ "App. __" sets forth the pages of the Joint Appendix to Briefs.

Judge Motley expressly determined "that there [was] a reasonable likelihood that Surgent [would] commit future violations of the federal securities law and consequently [that] permanent injunctive relief [was] justified under the circumstances of this case." (App. 33a).

Proceedings in the District Court

The Securities and Exchange Commission commenced this action on August 6, 1974, against three defendants who were alleged to have been involved in a manipulation of the over-the-counter market in the securities of Omni-Rx Health Systems, Inc. ("Omni-Rx"), in violation of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5 (App. 1a-5a). Defendant Ralph T. Iannelli was a registered representative employed at Pressman, Frohlich and Frost ("PF&F"), a member of the New York Stock Exchange registered with the Commission as a broker-dealer in securities (App. 42a). Defendant Howard Frost was president of PF&F and also supervised the firm's over-the-counter trading department; in the latter capacity he maintained a market in Omni-Rx for the firm during the period relevant to the Complaint (App. 43a). Defendant John Surgent, the appellant herein, is an attorney admitted to practice in the States of New Jersey and West Virginia, who made substantial trades in Omni-Rx stock as described below.

On August 7, 1974, the day after the Commission filed its Complaint, Iannelli and Frost, without admitting or denying the substantive allegations against them, consented to the entry of judgments of permanent

injunction. Final judgments against the two were filed by Judge Motley on August 14, 1974.

On August 9, 1974, the Commission moved the district court for a preliminary injunction against Surgent (App. 10a). That motion came on for hearing on October 23, 1974, at which time the district judge granted a request made by counsel for the Commission that the trial on the merits of its action against Surgent be advanced and consolidated with the hearing on motion for preliminary injunction (App. 37a). Upon submission of memoranda and affidavits by the parties, a stipulation as to certain of the relevant facts (App. 42a-51a) and the presentation of testimony at the hearing, Judge Motley filed her Findings of Fact and Conclusions of Law on January 29, 1975. The district court's order of permanent injunction, from which Mr. Surgent appeals here, was entered on February 19, 1975.

The Manipulative Scheme

PF&F was an active market maker in the common stock of Omni-Rx from May 1, 1973, until October 3, 1973. The Commission's Complaint charges that in the latter part of this period, on and after September 7, 1973, the defendant Iannelli manipulated the market in that stock and that defendant Frost and the appellant Surgent were aiders and abettors of that manipulation. (App. 1a-5a).

During the period relevant to the Commission's Complaint, September 7, 1973, through October 3, 1973, Iannelli generated trades involving over 100,000 shares of Omni-Rx stock, of which only 200,000 shares were publicly traded (App. 21a, 44a). Iannelli accomplished this

by ordering substantial purchases of Omni-Rx for the accounts of twenty-four of his customers without their prior knowledge or authorization (App. 44a). As a result of these purchases, the market price of Omni-Rx stock advanced sharply from approximately $6 per share to $12 per share within this period of less than one month (App. 21a, 44a).

The scheme was premised upon Iannelli's creating a rising market price for Omni-Rx through Iannelli's entry of unauthorized orders for the purchase of Omni-Rx stock in behalf of his customers. Iannelli expected that customers for whom unauthorized trades had been effected would later ratify these transactions in light of the artificially induced price increases between the date of purchase and the date of the proposed ratification (App. 44a). As anticipated, the price of Omni-Rx stock did advance substantially between the time the unauthorized purchases were made and the time when customers received confirmations for their "purchases" from Loeb, Rhodes & Co. ("Loeb"), the brokerage house through which PF&F cleared its business (App. 44a). But despite the increased prices, in virtually every instance customers, when apprised of the unauthorized purchases, refused to ratify them (App. 45a).

In order to keep the scheme afloat, therefore, Iannelli found it necessary to secure extensions of time for settlement with Loeb so that he could locate persons who would adopt the unauthorized transactions. This was accomplished by advising Loeb's margin department that payment had not been received from the "purchasing" customers and that more time was required in which to obtain payment (App. 45a).

One of the persons to whom Iannelli had attempted to sell the stock and for whose account he had made unauthorized purchases was Jack Wagenti (Tr. 27-28[2]), a former associate from another brokerage house, who in response to Iannelli's request for referral of potential purchasers, suggested the appellant John Surgent (App. 45a).[3] Surgent, who was familiar with Omni-Rx, expressed an interest, and during the period from approximately September 10 to September 26, 1973, Iannelli kept Surgent informed as to the price movements of Omni-Rx in the course of approximately five conversations (App. 46a).

By September 20, 1975, Surgent became an active participant in the scheme by telling defendant Howard Frost, Iannelli's superior at PF&F, that three unauthorized purchases made for the account of Jack Wagenti on September 13, 17 and 20, respectively, had been intended from the outset for Surgent's account and entered in Wagenti's account through error (Tr. 32). At Surgent's trial, Iannelli testified that he had deliberately made these unauthorized purchases for Wagenti's account, that confirmations had been sent to Wagenti, and that at one point Wagenti had been undecided as to whether or not to pay for the stock bought for his account (Tr. 26-28). Surgent has not disputed this testimony.

2/ "Tr. __" sets forth the pages of the transcript of hearing of October 23, 1974.

3/ Wagenti had been a client of Surgent's law firm and rented office space from the Surgent firm (Tr. 132). Surgent and Wagenti had discussed Omni-Rx before September 1973 (Tr. 133).

On September 25, 1973, Iannelli offered to sell Surgent Omni-Rx stock at prices substantially below the prevailing market price at that time (App. 46a), and on the following day, Surgent appeared in the offices of PF&F and agreed to adopt three purchases, which to his knowledge had been effected previously for the accounts of other customers and for which no payment had been made (Tr. 34, App. 36a). In agreeing to adopt these trades Surgent insisted that there be a simultaneous liquidation of the stock at the higher price level at the date of adoption (Tr. 34, App. 46a). Thus, at one stroke, Surgent was able to purchase 1900 shares of Omni-Rx at 6 7/8, 600 shares at 7 1/2 and another 1,000 shares at 7 1/2 and sell the 3,500 shares at 10 1/2 (App. 46a). Surgent effected these transactions for the account of the London Corporation, a family-held New Jersey company of which he was president (App. 22a, 46a). Surgent's trading presumably assisted Iannelli in concealing from PF&F, for at least several days, the manipulation Iannelli was conducting.

It is undisputed that the written confirmation of these initial trades (App. 22a) was dictated by appellant Surgent to defendant Iannelli, who first wrote it in longhand and then typed it (Tr. 36). At Surgent's direction, that confirmation letter falsely stated that "due to computer error your confirmation [of the earlier trades which had actually been made for other customers without their authorization] will follow in a few days" (App. 22a, 47a; Tr. 37).

The pattern of these initial transactions was repeated on several occasions within the following week.[4/] On September 28, 1973, Surgent adopted two trades of 2,000 shares each, which had been made without authorization in behalf of two other customers at $8 per share on September 11, 1973, and at $8 1/2 per share on September 12, 1973 (App. 48a). The agreement provided that these transactions would be simultaneously liquidated at $10 on the same conditions as Surgent had imposed with respect to the September 26 trades. And the transactions were memorialized by substantially the same written confirmation drawn by Surgent with its false reference to computer error (App. 23a, 48a).

On October 1, 1973, Surgent repeated the process in the name of Surgent and Surgent, a law partnership of which he was a member, adopting an earlier unauthorized purchase of 3000 shares at $8 1/2, with a simultaneous sale at $11, the market price on the date of adoption (App. 48a). On October 2, additional purchase orders were made for Surgent and Surgent adopting earlier unauthorized trades of 3,750 shares at $9 7/8 and 7,000 shares at $10 1/2; the simultaneous liquidation was at $12 per share (App. 49a). Also on October 2, Surgent entered the same kind of purchase and sale transaction in behalf of Premium Finance Corporation, of which he was president: the unauthorized purchase adopted had been entered at

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4/ By September 26, 1973, the extensions of time for settlement obtained from Loeb were expiring and Iannelli had been unable to locate sufficient persons willing to adopt the unauthorized trades (App. 45a).

$9 1/4 for 7,000 shares; the simultaneous sale was at $11 1/4, the market price on the date of adoption (App. 50a). In each instance, the false confirmation letter dictated by Surgent was tendered by Iannelli (App. 24a, 25a, 49a, 50a).

The manipulative scheme began to collapse on October 3, 1973, when someone at Loeb perceived the inter-relationship between the three Surgent accounts (The London Corporation, Surgent & Surgent, and Premium Finance Corporation). Loeb then declined to pay the proceeds of Surgent's September 26 sale transaction until checks for subsequent purchases by Surgent could be certified (App. 51a). On October 4, Loeb was unable to certify the Surgent checks; at the same time both Loeb and PF&F began to receive letters from customers of Iannelli disclaiming knowledge of their purported purchases of Omni-Rx stock. These communications from customers along with Surgent's uncertifiable checks led to a review of Iannelli's trading activities and to discovery of the manipulative scheme. (App. 51a).

ARGUMENT

HAVING FOUND THAT THE APPELLANT KNEW OR SHOULD HAVE KNOWN THAT HE WAS AIDING AND ABETTING ILLEGAL ACTIVITY ON THE PART OF A CO-DEFENDANT, THE DISTRICT COURT CORRECTLY DETERMINED THAT AN INJUNCTION AGAINST FURTHER VIOLATIONS SHOULD ISSUE.

A. The district court correctly determined the liability of the appellant as an aider and abettor of violations of the federal securities laws.

The district judge determined "that Surgent knew, or should have known, what Iannelli had done and that he, by his actions, was assisting Iannelli in concealing the unauthorized purchases and effectuating Iannelli's scheme" (App. 40a). The record before this Court is replete with evidence in support of that finding and conclusion.[5/] In the Commission's view, the undisputed evidence of Surgent's affirmative efforts to conceal Iannelli's activities from a supervisor at PF&F (Tr. 32) and to characterize his own purchases falsely in confirmation letters of his own composition (Tr. 36-37), taken together with the availability of sizeable instant profits (Tr. 34, App. 46a) from transactions effected in a manner inconsistent with the usual industry practice, would fully support a finding of actual knowledge of the fraudulent scheme on Surgent's part. But a finding of actual knowledge is not necessary to establish the liability of a defendant under the anti-fraud provisions (see discussion, infra, pp. 12-13); and there can be no serious question that the evidence supports the conclusion that a man of the appellant's sophistication should have known that he was aiding and abetting a fraudulent scheme.

5/ A district court's findings of fact "shall not be set aside unless clearly erroneous." Federal Rules of Civil Procedure, Rule 52(a). Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 393 (C.A. 2, 1973), certiorari denied, 414 U.S. 918 (1974); Lassiter v. Fleming, 473 F.2d 1374, 1375 (C.A. 2, 1973).

Mr. Surgent's perception of the trading activity in which he became integrally involved must be assessed from the perspective of Judge Motley's determination that Surgent "was a sophisticated, knowledgeable trader in securities . . ." (App. 33a). Evidence with respect to Surgent's ties to the securities industry and his familiarity with it are undisputed (App. 45a).[6/]

Mr. Surgent was not a spectator to the events surrounding the manipulation of Omni-Rx's over-the-counter market. He was actively involved with Iannelli's day-to-day activities during the relevant period and was possessed of information which could not have failed to signal manipulative activity to a man of Mr. Surgent's sophistication. In early September, Surgent made himself aware of the rapidly advancing price of Omni-Rx stock through frequent contacts with Iannelli (Tr. 46).

On September 25, 1973, he was offered large blocks of the over-the-counter stock at prices substantially below the market price, his profits guaranteed. (Tr. 88, App. 46a). On September 26 and on four subsequent occasions, Surgent adopted purchases which had been executed previously on behalf of other customers and for which they had not made payment (Tr. 107).

He affirmatively misrepresented to Howard Frost, PF&F's president and over-the-counter trader, that three substantial purchases made by Iannelli for the account of Jack Wagenti had been intended for Surgent

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6/ The parties have stipulated, among other things, that Surgent has been an extremely active trader in securities once having had a ticker in his office and having been termed a "big hitter" by his own broker. It was also stipulated that Surgent has represented a broker-dealer client in matters before the Commission (App. 45a).

and placed in Wagenti's account through error (Tr. 32). As Judge Motley correctly concluded, "This misrepresentation was crucial since it prevented discovery [by Iannelli's superiors] at that time of the fact that these particular purchases had been unauthorized by Wagenti" (App. 39a-40a).

Surgent never inquired as to the reason for the availability of Omni-Rx stock at prices substantially below the then prevailing market prices nor as to the reason why so many shares were available due to non-payment by a number of other customers (Tr. 34, 59, 135). On the contrary, in an affirmative effort to becloud the circumstances under which the shares had originally been "purchased" by these other customers, he required Iannelli to prepare confirmation letters which falsely recited that his [Surgent's] confirmations on these adopted trades had been delayed by computer error. In this effort to shield the unauthorized trades as originally effected, Surgent contributed directly to the perpetration of the fraud. The district court correctly found that the record reflected "a deliberate effort on Surgent's part to assist in the realization of an illegal profit." (App. 40a).

It is clear that in order to establish the liability of a defendant as an aider and abettor of a fraudulent scheme in violation of the federal securities laws the Commission is not required to demonstrate that the alleged aider and abettor had actual knowledge of the fraudulent scheme. Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 541 (C.A. 2, 1973). This Court has repeatedly held that in the context of enforcement proceedings seeking equitable or prophylactic relief, it is

sufficient to establish liability if the defendant should have known of the violative nature of the conduct. Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801, 811 (C.A. 2, 1975); Securities and Exchange Commission v. Spectrum, Ltd., supra, 489 F.2d at 541; Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096 (C.A. 2, 1972); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-855 (C.A. 2, 1968) (en banc), certiorari denied, sub nom. Kline v. Securities and Exchange Commission, 394 U.S. 976 (1969).[7/] Thus, it is sufficient if a district court finds that the alleged aider and abettor "should have been able to conclude

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7/ Contrary to the law in this Circuit, appellant, in his brief at page 5, cites a number of cases which purportedly support the proposition that "the accused party [must have] general awareness that his role was part of the overall activity that is improper." From his activities in this case it appears that appellant must have had such "general awareness," but that is not the test in this Circuit for injunctive actions brought by the Securities and Exchange Commission. Four of the cases cited by the appellant are criminal cases or private actions for damages and, hence, inapplicable here. Consistent with the Commission's argument here, in Securities and Exchange Commission v. National Bankers Life Insurance Co., 324 F. Supp. 189, 196 (N.D. Tex.), aff'd, 448 F. 2d 652 (C.A. 5 1971), the district court expressly held one of the defendants liable for violations because "he knew or should have known of the improper sales . . ." (emphasis added). While in Securities and Exchange Commission v. Advance Growth Capital, 470 F. 2d 40, 52 (C.A. 7, 1970), a defendant held liable as an aider and abettor was found to have had actual knowledge, there is no statement by the court that such a finding was essential.

In the remaining case cited, Securities and Exchange Commission v. Coffey, 493 F. 2d 1304, 1316 (1974), certiorari denied, 420 U.S. 908 (1975), the Court of Appeals for the Sixth Circuit did say that a defendant may be held liable as an aider or abettor "if the accused party had general awareness that his role was part

(continued)

that his act was likely to be used in furtherance of illegal activity." Securities and Exchange Commission v. Management Dynamics, Inc., supra, 8/ 515 F. 2d at 811.

B. Having determined that violations had occurred, the district court did not abuse its discretion in entering its order of permanent injunction.

Section 20(b) of the Securities Act, 15 U.S.C. 77t(b), provides that the Commission may bring an action in an appropriate United States District Court to enjoin acts or practices which constitute or will constitute violations of the Act, and that "upon a proper showing a permanent or temporary injunction . . . shall be granted . . . ." This Court has repeatedly held that the Commission has made a proper showing sufficient to permit injunctive relief where there is a reasonable expectation of future violations by the defendants; it has also held that such an expectation of future violations may be inferred from past violations. Securities and Exchange Commission v. Shapiro, 494 F. 2d 1301,

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7/ (continued)

of an overall activity that is improper, and if the accused aider and abetter knowingly and substantially assisted in the violation." In applying that standard the court of appeals distinguished this Court's decision in Spectrum Ltd., supra, noting an absence in their case of "some showing that Appellants were aware of the . . . alleged misrepresentations." In the light of this distinction, it is doutbful that that court of appeals would apply the Coffey test where, as here, there was proof of misrepresentations by the alleged aider and abettor in support of the scheme.

8/ In Management Dynamics, this Court vacated a preliminary injunction entered against one of the defendants as an aider and abettor of violations of the registration provisions of the Securities Act. The preliminary injunction was vacated, however, on the basis that this Court "perceive[d] no reason why Nadino should have assumed that an attempt to violate the registration provisions would occur, and that his activity would aid such a violation." 515 F. 2d at 811.

1308 (1974); Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F. 2d at 1100; Securities and Exchange Commission v. Culpepper, 270 F. 2d 241, 249-250 (1959).

As this Court stated in Securities and Exchange Commission v. Manor Nursing Centers, supra, 458 F. 2d at 1100:

> "a district court has broad discretion to enjoin possible future violations of law where past violations have been shown, and the court's determination that the public interest requires the imposition of a permanent restraint should not be disturbed on appeal unless there has been a clear abuse of discretion" (citations omitted).

It may be true that prior to Mr. Surgent's involvement in the Omni-Rx manipulation he was never found to have been involved in unlawful securities activities. But "'first offenders' are not immune from injunctive relief." Securities and Exchange Commission v. Shapiro, supra, 494 F. 2d at 1308. There, this Court found it significant that the enjoined first offender "had made not one but seven purchases [in possession of inside information] in the space of six weeks." Id., p. 1308. The facts upon which Mr. Surgent has been enjoined are even more compelling. He was totally immersed in the manipulative scheme and during the crucial period he was present at PF&F alongside Iannelli virtually every day (Tr. 114). On five occasions, he adopted trades which he knew to have been made for the accounts of numerous other customers at prices well below the prevailing market, exacting Iannelli's agreement to liquidate these purchases simultaneously in order to realize an instant profit. (App. 46a-50a). Indeed, Surgent, perhaps more than anyone else, acted affirmatively to conceal the real nature of the trading activity in Omni-Rx

by his authorship of false confirmation letters calculated to conceal the pivitol fact that his purported original purchases of stock were actually adoptions of unauthorized trades entered previously in the accounts of others (Tr. 36-37). And had Surgent not misrepresented certain facts to a supervisor at PF&F the manipulation engineered by Iannelli might have been thwarted significantly sooner than it was (Tr. 30-32).

Upon this record, it cannot be seriously contended that in permanently enjoining Mr. Surgent from further violations the district judge clearly abused her discretion. Mr. Surgent "who has displayed such frailty in the past" and who (as an active securities trader) may face "so many temptations in the future, may well need the admonition of an injunction to obey the law." Securities and Exchange Commission v. Shapiro, supra, 494 F. 2d at 1308.

CONCLUSION

For the foregoing reasons the district court's order of permanent injuction should be affirmed.

Respectfully submitted,

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September, 1975

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October 3, 1975

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Re: Securities and Exchange Commission v. Iannelli, et al.,
No. 75-6045

Dear Mr. Fusaro:

Enclosed for filing are twenty-five copies of the Commission's answering brief as appellee.

I certify that I have caused two copies of the Commission's brief to be served by mail upon Jay D. Fischer, Esquire, counsel to the appellant, at 992 Clifton Avenue, Clifton, New Jersey 07013.

Very truly yours,

John M. Mahoney

John M. Mahoney,
Attorney

Enclosures